

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-01  
INR-07 NSAE-00 USIA-15 TRSE-00 XMB-04 OPIC-06  
SP-02 LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-06  
CEA-01 PA-02 PRS-01 /097 W  
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R 272311Z JAN 78  
FM AMEMBASSY OTTAWA  
TO SECSTATE WASHDC 6126  
INFO AMCONSUL CALGARY  
AMCONSUL MONTREAL  
AMCONSUL TORONTO  
ALL OTHER CONGENS IN CANADA BY POUCH

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DEPT. PASS CEA, TREAS, FRB

E.O. 11652:N/A  
TAGS: ECON, EFIN, CA  
SUBJECT: THE CONTRIBUTION OF FOREIGN CAPITAL TO CANADIAN  
ECONOMIC GROWTH

REF: TORONTO 102

1. UNIVERSITY OF ALBERTA PROFESSOR THOMAS POWRIE HAS  
RECENTLY PUBLISHED THE SUBJECT STUDY WHICH CONCLUDES IN  
PART THAT, UNDER CERTAIN RESTRICTIVE (AND UNREALISTIC)  
CONDITIONS, FOREIGN CAPITAL MAKES A NEGLIGIBLE CONTRIBUTION  
TO CANADIAN ECONOMIC GROWTH. EDMONTON PUBLISHER, MEL  
HURTIG, HAS SPONSORED THE STUDY AND PRODUCED A LIBERAL  
INTERPRETATION (INCLUDING CONSIDERABLE BENDING AND TWIST-  
ING) OF ITS CONCLUSIONS IN HIS INTRODUCTION TO THE MAIN  
PAPER. MORE OBJECTIVE COMMENTORS HAVE ALSO EMPHASIZED  
POWRIE'S CONCLUSION THAT FOREIGN INVESTMENT HAS MINIMAL  
IMPACT ON GROWTH. COPIES OF THE STUDY AND HURTIG'S INTRO-  
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DUCTION POUCH TO WASHINGTON.

2. IN HIS STUDY POWRIE USES A PRODUCTION FUNCTION APPROACH  
TO ANALYSE THE IMPACT OF FOREIGN INVESTMENT (BOTH DIRECT  
AND PORTFOLIO) ON OUTPUT AND EXAMINES THE EFFECT OF ELIMI-  
NATING FOREIGN INVESTMENT UNDER THREE ALTERNATIVE ASSUMP-  
TIONS.

(A) RIGID CAPITAL/LABOR RATIOS - I.E. NO SUBSTITUTION IN PRODUCTION BETWEEN CAPITAL AND LABOR. NEITHER INVESTMENT NOR SAVINGS ARE SENSITIVE TO CHANGES IN INTEREST RATES.

(B) CAPITAL AND LABOR ARE PERFECTLY AND INSTANTANEOUSLY SUBSTITUTABLE; NEITHER INVESTMENT NOR SAVINGS RESPOND TO INTEREST RATE CHANGES.

(C) CAPITAL AND LABOR ARE FREELY SUBSTITUTABLE; INVESTMENT AND SAVINGS DO RESPOND TO INTEREST RATE CHANGES. IN CASE (A), POWRIE FINDS THAT NATIONAL INCOME IN 1976 WOULD HAVE BEEN 22 PERCENT LOWER IN THE ABSENCE OF FOREIGN INVESTMENT. POWRIE CONCLUDES THAT "IN THE IMPROBABLE EVENT THAT THE CANADIAN ECONOMY IS SO INFLEXIBLE AS TO BE DESCRIBED BY CASE (A), THE NEED FOR MORE AND MORE FOREIGN SAVINGS IS PROFOUND." THIS NEED WOULD ALSO GROW RAPIDLY IN THE FUTURE.

ON THE BASIS OF CASE (B) ASSUMPTIONS, POWRIE FINDS THAT ELIMINATING FOREIGN INVESTMENT WOULD ONLY HAVE REDUCED 1976 NATIONAL INCOME BY 2.2 PERCENT OF ITS ACTUAL LEVEL. THE GAP WOULD NOT INCREASE IN THE FUTURE. IT IS THIS CONCLUSION WHICH HAS RECEIVED ALL THE PRESS ATTENTION. POWRIE IS CONSISTENT IN POINTING OUT THAT WHERE CAPITAL AND LABOR ARE PERFECTLY SUBSTITUTABLE, DOMESTIC INVESTMENT UNCLASSIFIED

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IS OF NO IMPORTANCE TO GROWTH EITHER. THIS WOULD IMPLY, FOR EXAMPLE, THAT THE DOLS 16.2 BILLION JAMES BAY PROJECT COULD BE BUILT WITHOUT ANY CAPITAL, FOREIGN OR DOMESTIC. HURTIG AND THE PRESS PASSED OVER THIS CONCLUSION.

CASE (C) WAS AN ECONOMETRIC DISASTER; ITS CONCLUSIONS ARE SIMILAR TO THOSE OF CASE (B).

3. COMMENT. POWRIE REJECTS CASE (A), RIGID CAPITAL/LABOR RATIOS, AS BEING AN UNREALISTIC DESCRIPTION OF THE CANADIAN ECONOMY. HOWEVER, THE ASSUMPTION OF PERFECT SUBSTITUTABILITY OF FACTOR INPUTS IS EQUALLY UNREALISTIC. THEREFORE, WHILE THE ELIMINATION OF FOREIGN CAPITAL MIGHT NOT HAVE "PROFOUND" EFFECTS ON CANADIAN GROWTH, THE EFFECT WOULD BE VERY SIGNIFICANT, BORDERING ON THE PROFOUND. MOREOVER, IT IS DIFFICULT TO TAKE SERIOUSLY A STUDY WHICH CONCLUDES THAT INVESTMENT, FOREIGN OR DOMESTIC, HAS ALMOST NO EFFECT ON ECONOMIC GROWTH.

POWRIE'S DEFINITION OF NATIONAL INCOME IS INCOME WHICH IS OWNED BY CANADIANS. IT THEREFORE EXCLUDES REINVESTED EARNINGS OF FOREIGN SUBSIDIARIES. THUS, SINCE IN DEFINING

ACTUAL OUTPUT POWRIE EXCLUDES AN IMPORTANT BENEFIT DERIVED FROM FOREIGN INVESTMENT, THE ADVERSE EFFECTS OF ELIMINATING FOREIGN INVESTMENT WOULD BE REDUCED.

POWRIE CALCULATES THAT FOREIGN CAPITAL FINANCES 18 PERCENT OF GROSS CAPITAL FORMATION ON AVERAGE AND THAT CAPITAL ACCOUNTS FOR 32 PERCENT OF NATIONAL INCOME. THUS, ACCORDING TO POWRIE, THE DRAG ON GROWTH FROM FOREIGN INVESTMENT IS 5.8 PERCENT OF NATIONAL INCOME (3.8 PERCENT AFTER TAKING INTO ACCOUNT GOC TAXES ON FOREIGN INCOME.). HOWEVER, ONLY THAT PORTION OF FOREIGN INCOME REMITTED ABROAD (AND WHICH IS NOT REINVESTED) CAN IN ANY SENSE BE CONSIDERED A "DRAG" ON GROWTH. CONSEQUENTLY, POWRIE UNDERESTIMATES THE NET CONTRIBUTION OF FOREIGN INVESTMENT TO GROWTH AND MUST

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THEREFORE UNDERESTIMATE THE LOSS DUE TO ELIMINATING FOREIGN INVESTMENT.

POWRIE ASSUMES THAT LABOR PRODUCTIVITY IS CONSTANT. THEREFORE, IN THE CASE OF PERFECT FACTOR SUBSTITUTABILITY,

NEITHER THE QUANTITY OF LABOR NOR ITS PRODUCTIVITY ARE  
ALTERED WHEN FOREIGN INVESTMENT IS REMOVED. IN SUCH A  
CASE, ONE WOULD NOT EXPECT MUCH CHANGE IN OUTPUT. IT IS  
HARDLY REALISTIC (OR THEORETICALLY SOUND) TO EXPECT LABOR  
PRODUCTIVITY TO REMAIN CONSTANT WITH A DECLINE IN THE  
GROWTH OF THE CAPITAL STOCK. ENDERS

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## Message Attributes

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**Current Classification:** UNCLASSIFIED  
**Concepts:** ECONOMIC CONDITIONS, FOREIGN INVESTMENTS  
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